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Why India is attracting FDI

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IN THE WORLD Economic Outlook (WEO) released in Davos, Switzerland, IMF Chief Economist Gita Gopinath said that the economic slowdown in India has pushed down global growth forecast by "0.1%." The International Monetary Fund (IMF) has slashed India's forecast to 4.8%, a reduction of 1.3% within three months. In fact, today, a wave of retreat from globalisation is getting strengthened, and how it has affected India's external sector and, in turn, economic growth is an intriguing analysis.

The US-China trade tensions are also a matter of concern. We looked into the latest report, the '*Investment Trends Monitor*' published by the UNCTAD, which reveals that India has gained by 16% in terms of FDI inflows, from $42 billion to $49 billion, holding its position amongst top 10 FDI inflow-host countries. This is when the global FDI remained almost flat in 2019, at $1.39 trillion, a decline of 1% from $1.41 trillion.

India's foreign exchange (forex) reserves also dilated at an all-time high at $461.214 billion, as reported on January 10, 2020, published in the '*RBI Weekly Statistical Supplement: Foreign Exchange Reserves*' dated January 17—starting the year with an increase of $65.1294 billion since January 4, 2019, roughly equivalent to the forex reserves of Australia, Finland and Iceland combined.

Is surging forex a comfortable macro indicator amidst the stagnating consumption and growth slowdown? The empirical evidence is not in affirmative to this, as can be seen from the ADB paper by Fukuda and Kon (2010), titled '*Macroeconomic Impacts of Foreign Exchange Reserve Accumulation: Theory and International Evidence*', which shows that the increase in forex reserves results in permanent decline in consumption, depreciation of real exchange rate, and temporal improvement in current account.

In India, the reason for a surging forex is the component 'foreign currency assets' (FCA). It increased by 10% when compared to March 2019. FCA is maintained as a multi-currency portfolio comprising major currencies such as the dollar, euro, pound sterling, Japanese yen, etc, and is valued in terms of dollars. As per the RBI report, "the variations in the FCA occur mainly on account of purchase and sale of foreign exchange by RBI, income arising out of the deployment of forex reserves, external aid receipts of the central government and changes on account of revaluation of assets."

Apart from FCA, the other three components of forex are gold, SDR (Special Drawing Rights) and RTP (Reserve Tranche Position) in the IMF. FCA constitutes 93% of total forex, while gold is 6%, SDR is 0.32%, and RTP in the IMF is 0.8%, as on December 20, 2019. The demands on forex reserves are determined by the size of the external sector to GDP ratio, the degree of openness of the economy, and liquidity requirements. The essential legal framework for reserve management is the RBI Act of 1934.

In order to understand the variations in sources to forex, one needs to see both current account (trade deficit) and capital account of the Balance of Payments (BoP) statement. Capital account has two significant components—FDI and FPI (foreign portfolio investment). Within FPI, the significant components are foreign investors investment (FII), banking capital including NRI deposits, short-term credit, external assistance, and external commercial borrowings. The 'other items' (miscellaneous) in capital account apart from 'errors and omissions' include SDR allocations, leads, and lags in exports, funds held abroad, advances received a pending issue of shares under FDI and capital receipts not included elsewhere and rupee-denominated debt. This recent surge in forex is due to the improvement in the trade deficit (X-M), and also increased inflows to FDI and FII.

Now, what is the significance of a surging forex and how is the adequacy of forex reserve measured? The adequacy of forex reserves depends upon the ability to cover imports. In this fiscal year, the forex reserves cover of imports has increased from 9.6 months in March 2019 to 10 months in June 2019.

Another factor to examine is whether our booming forex reserves stable or volatile? This depends upon the composition of forex. If volatile capital flows—for instance, FPI and outstanding short-term debt—are significantly higher components of forex, then forex reserves are not stable. This is because FPI is broadly 'hot money', which, by definition, is responsive to interest rate differentials and flow out of the country if the interest rate of the rest of the world is higher than our interest rates.

As per the recent RBI *Report on Forex Management*, "the ratio of volatile capital flows (including cumulative portfolio inflows and outstanding short-term debt) to reserves declined from 88.7% at end-March 2019 to 86.7% at end-June 2019." So, it is an irony to find macroeconomic certainty in the booming forex when the global economy is in recession, and there is a glut in the domestic market. Given the economic downturn, we need to focus more on structural reforms related to fiscal and financial sector from a long-term perspective, rather than focusing just on booming forex reserves.

Coming to FDI, India amongst the top 10 countries, even as both the US and China saw a flat FDI with zero growth of capital inflows. The South Asian region recorded 10% increase in FDI to $60 billion, with India holding more than 80% of it. The majority went to services industries, including IT. Our neighbours, Bangladesh and Pakistan, faced a decline in FDI of 6% and 20%, respectively, to $3.4 billion and $1.9 billion.

The political upheaval across the globe had an impact on the flow of FDI: with the UK facing a decline of 6% following the unfolding of Brexit, and the EU facing a reduction by 15% to $305 billion; Brazil, however, gained 26% at the start of the privatisation programme. The political economy is a crucial determinant for FDI inflows and political events can definitely act as a disruption for foreign investment.

Developing economies continue to absorb more than half of global FDI flows and half of top largest receipts—China, Singapore, Brazil, Hong Kong and India, at an estimated $695 billion. The US held its top position even with a 1% decline, at $251 billion.

The UN report also emphasises that cross-border M&As decreased by 40% in 2019, to $490 billion—the lowest level since 2014. The fall in global cross-border M&As sales was most rooted in the services sector with a decline of 56%, to $207 billion, followed by manufacturing with a decrease by 19% to $249 billion and the primary sector, with a decline of 14%, to $34 billion. The decline of cross-border M&As in 2019, which is 40%, is much stronger than the 14% decline in the total M&A activity (including domestic deals) worldwide.

But the UN report also has a positive observation, saying that "FDI flows are still expected to rise moderately in 2020, as current projections show the global economy to improve."

The impact of the surge in FDI on economic growth is an empirical question and needs to be analysed in the long run. The government of India's on-going structural reforms in the fiscal and financial sectors are crucial for economic growth and macroeconomic stability.